STATE OF MICHIGAN

COURT OF APPEALS

REYNOLDS METALS COMPANY, LLC, Plaintiff-Appellee,	UNPUBLISHED March 20, 2012
v	No. 300001 Court of Claims
DEPARTMENT OF TREASURY, Defendant-Appellant.	LC No. 08-000068-MT

Before: HOEKSTRA, P.J., and CAVANAGH and BORRELLO, JJ.

PER CURIAM.

Defendant Michigan Department of Treasury appeals as of right the Court of Claims order holding that Michigan was precluded from including plaintiff Reynolds Metals Company's (Reynolds) capital gains from the sale of a foreign joint venture in its single business tax (SBT) tax base. For the reasons stated in this opinion, we affirm.

I. FACTUAL BACKGROUND

Reynolds is a Delaware corporation with its commercial domicile and headquarters in Virginia. Reynolds is a manufacturer, distributor, and marketer of aluminum products. During the year in question, Reynolds had no production or manufacturing facilities in Michigan, but did have salespeople and a warehousing and distribution operation in Michigan. It is undisputed that Reynolds transacted business in Michigan at all relevant times.

The instant dispute arises from the Treasury's calculation of Reynolds' SBT tax base. The Treasury included capital gains from Reynolds' sale of a foreign joint venture in Reynolds' SBT tax base. Reynolds disputed the inclusion, because it claimed that the inclusion violated the unitary business principle.

The foreign joint venture at issue is the Worsley Joint Venture ("Worsley"), a venture based in Australia entered into in 1980 by Reynolds and three other aluminum companies for the mining and refining of alumina, a product used to produce aluminum. Reynolds' interest in Worsley was held by Reynolds Australia Alumina Ltd (RAAL), a wholly owned corporate subsidiary formed by Reynolds. The day-to-day operations of Worsley were managed through Worsley Alumina Proprietary Limited (WAPL), an independent management company that reported to RAAL and the three other joint venturers. Major decisions were made by an executive committee, which was composed of members nominated by each joint venturer. Each

joint venturer had the right to nominate three executive committee members, regardless of ownership interest.

RAAL had two employees, both of whom were in Australia. One employee was an administrator and the other was the vice president of RAAL. The RAAL employees were responsible for tax issues and other administrative matters that arose in Australia but were not involved in the management or operations of WAPL or Worsley. The RAAL employees interacted with Reynolds and coordinated activity with WAPL to ensure that WAPL got approval from the Reynolds representatives on the executive committee. RAAL had no business activity in Michigan.

The mining and refining of bauxite deposits was conducted by WAPL through the management agreement with Worsley. WAPL mined the bauxite deposits and then sent the bauxite to a refinery where it was refined into alumina. After WAPL refined the bauxite, RAAL received its share of the alumina based on its ownership interest in the joint venture. RAAL sold one hundred percent of the alumina it received to Reynolds, and all sales between RAAL and Reynolds were conducted at arms-length prices, meaning the sales were for fair market value. After purchasing the alumina from RAAL, Reynolds sold approximately thirty percent of it to third parties and retained seventy percent for its own operations.

In 2000, Alcoa, Inc. acquired Reynolds through a merger. Alcoa's acquisition of Reynolds was subject to antitrust review by the United States Department of Justice and the European Union. As part of the review, Reynolds was required to dispose of its interest in Worsley. Accordingly, in 2001, Reynolds sold RAAL. The sale of RAAL was actually the sale of Worsley because RAAL was a disregarded entity, and all of its assets became the assets of Reynolds. The RAAL sale resulted in the realization of approximately $950 million in capital gains. The gain was included in Reynolds' corporate income for federal tax purposes; however, Reynolds excluded the RAAL gain from its tax base when determining its Michigan business tax liability under the SBT.

The Treasury audited Reynolds' tax return for 2001, concluded that the RAAL gain was includable in Reynolds' tax base, and issued an intent to assess the amount of $438,411, plus interest. The assessment was affirmed by the Treasury, and a final assessment in the amount of $603,889.29 was issued in April 2008. Reynolds paid the assessment under protest and filed a complaint in the Court of Claims. After conducting discovery, Reynolds moved for partial summary disposition pursuant to MCR 2.116(C)(8) and (C)(10), arguing that the unitary business principle applied to the SBT. The Treasury responded, and argued that the unitary business principle had no application to the SBT because the SBT is a value-added tax. After hearing arguments, the Court of Claims issued an opinion and order granting partial summary disposition in favor of Reynolds, finding that the unitary business principle applied to the SBT.

After the Court of Claims' determination that the unitary business principle was applicable, a bench trial was held regarding whether the RAAL gain was includable in Reynolds' SBT tax base. Allen Earehart, Reynolds' former senior vice president, testified regarding Worsley. Earehart stated that neither Reynolds nor RAAL maintained control over Worsley. Earehart stated that Reynolds had input into Worsley only to the extent Reynolds had members on the executive committee. Earehart also stated that WAPL was in charge of the day-to-day

operations of the joint venture, and the only thing the executive committee did was approve purchases over five million dollars. Earehart further stated that Reynolds and RAAL were not involved in the management of WAPL. Earehart stated that WAPL had its own facilities separate from Reynolds' facilities. WAPL had its own separate bank accounts, purchasing, warehousing, and management. Any research done by WAPL was separate from RAAL and Reynolds.

Earehart further testified that there was no functional integration between Reynolds and Worsley or WAPL. Additionally, he was unaware of any economies of scale between Reynolds and Worsley or WAPL. David Gellatly, Reynolds' former manager of international tax analysis, also testified at trial. Gellatly stated that there was no centralized management or economies of scale between Reynolds and Worsley or WAPL.

Reynolds called two experts to testify at the trial. Professor Kenneth Boudreaux testified as an expert in corporate finance and economics. Professor Boudreaux testified that based on the evidence he reviewed, Reynolds had no active role in the management of Worsley. Professor Boudreaux stated that there was no functional integration, centralized management, or economies of scale between Reynolds and Worsley or WAPL. Boudreaux testified that from an economic standpoint, "Reynolds Metals was, in fact, RAAL, and the activity and the oversight board of the joint venture, though it was called RAAL, was really Reynolds Metals." Finally, Professor Boudreaux stated that the capital gains from the sale of RAAL was a unique transaction and was not derived from a source functionally integrated with Reynolds Metals.

Professor Richard Pomp testified as an expert on tax policy. Professor Pomp testified that Reynolds and Worsley were not run as a unitary business. Professor Pomp stated that centralized management, functional integration, and economies of scale were needed for a unitary business. Professor Pomp stated that there was no centralized management between Reynolds and Worsley. Control was needed for centralized management, but Reynolds did not control a majority of the seats on the executive committee. Further, WAPL managed and operated the joint venture's mining and refining operation. Therefore, Reynolds had no ability to control the joint venture. Additionally, Professor Pomp stated that there was no functional integration. Functional integration would focus on Reynolds and Worsley because RAAL did not really exist. Further, even if RAAL existed, it was a holding company and should not be respected as a true bona fide substantive operating company. The substance of the transaction was the sale of Worsley. Finally, Professor Pomp stated that there was absolutely no indication that Worsley or WAPL created any kind of economies of scale for Reynolds.

The Court of Claims issued an opinion and order reversing the inclusion of the capital gains from the sale of Reynolds' interest in Worsley in Reynolds' SBT tax base. The Court of Claims recognized that the due process clause allows states to tax a multistate business on an apportionable share of the multistate activity carried on in the taxing state; however, it held that the linchpin of apportionality is the unitary business principle, "which requires that the taxpayers' intrastate and extra state activities form part of a single unitary business." The Court of Claims determined that Reynolds, through its ownership of RAAL, did not operate a unitary business with Worsley. There was little functional integration or centralized management between Reynolds/RAAL and Worsley. Further, no economies of scale existed between Reynolds/RAAL and Worsley. The Court of Claims concluded that Reynolds and Worsley were

insufficiently connected to permit classifying the two companies as a unitary business. Accordingly, the Court of Claims ordered the Treasury to refund the tax and interest paid by Reynolds.

II. APPLICABILITY OF THE UNITARY BUSINESS PRINCIPLE

On appeal, the Treasury first argues that the Court of Claims erred when it granted partial summary disposition in favor of Reynolds because the unitary business principle is inapplicable to the SBT.

We review a decision to grant summary disposition de novo. *Coblentz v City of Novi*, 475 Mich 558, 567; 719 NW2d 73 (2006). Summary disposition pursuant to MCR 2.116(C)(8) is proper if the nonmoving party failed to state a claim on which relief can be granted. *Kuznar v Raksha Corp*, 481 Mich 169, 176; 750 NW2d 121 (2008). In reviewing a grant of summary disposition pursuant to MCR 2.116(C)(8), we review the pleadings alone, accepting all factual allegations in the complaint as true and construing them in a light most favorable to the nonmoving party. *Id.* Summary disposition pursuant to MCR 2.116(C)(10) tests the factual support for a claim based on the affidavits, pleadings, depositions, admissions, and other evidence submitted by the parties. *Coblentz*, 475 Mich at 567. The evidence is viewed in the light most favorable to the nonmoving party. *Id.* at 567-568. "Where the proffered evidence fails to establish a genuine issue regarding any material fact, the moving party is entitled to a judgment as a matter of law." *Maiden v Rozwood*, 461 Mich 109, 120; 597 NW2d 817 (1999). We also review de novo questions of constitutional and statutory construction. *Fluor Enterprises, Inc v Dep't of Treasury*, 477 Mich 170, 174; 730 NW2d 722 (2007).

Before it was repealed, the Single Business Tax Act (SBTA), MCL 208.1 *et seq.*[1] imposed a value-added tax on business activity in Michigan. MCL 208.31; *Trinova Corp v Mich Dep't of Treasury*, 498 US 358, 367; 111 S Ct 818; 112 L Ed 2d 884 (1991). Value-added taxes are designed to measure and tax the activity and contribution an economic enterprise adds to the economy, as opposed to an income tax, which taxes the return received from supplying those resources to the economy. *Ammex, Inc v Dep't of Treasury*, 273 Mich App 623, 629; 732 NW2d 116 (2007). In *Mobil Oil Corp v Comm'r of Taxes of Vermont*, 445 US 425, 436; 100 S Ct 1223; 63 L Ed 2d 510 (1980), the United States Supreme Court reiterated that a state may not tax value earned outside of its borders; however, businesses operating in interstate commerce are not immune from fairly apportioned state taxation. "For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Id.* at 436-437.

For purposes of satisfying the Due Process Clause, "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439. The unitary business principle permits a state to avoid attempts to isolate the intrastate income-producing activities of

[1] For tax years beginning after December 31, 2009, the SBTA has been repealed.

a business; instead a state may tax an apportioned sum of the multistate business if the business is unitary. *Allied-Signal, Inc v New Jersey Div of Taxation*, 504 US 768, 772; 112 S Ct 2251; 119 L Ed 2d 533 (1992). "A state may not tax a nondomiciliary corporation's income, however, if it is derived from unrelated business activity which constitutes a discrete business enterprise." *Id.* at 773 (quotation and citation omitted). Accordingly, a state tax is constitutional so long as it adheres to the unitary business principle. *Id.* at 773, 777-778.

In this case, the Treasury specifically argues that the unitary business principal is not applicable to the SBT because in *Wismer & Becker Contracting Engineers v Dep't of Treasury*, 146 Mich App 690; 382 NW2d 505 (1985), this Court considered the application of the unitary business principle to the SBT and determined that it had no application.

The *Wismer & Becker Contracting Engineers* decision is not binding on this Court. MCR 7.215(J)(1). Further, contrary to the Treasury's assertion, this Court in *Wismer & Becker Contracting Engineers* did not hold that the unitary business principal was inapplicable to the SBT. The issue this Court addressed in *Wismer & Becker Contracting Engineers* was whether separate entities, which act as a unitary business, may file their SBT return together utilizing the unitary business principle. *Id.* at 693-694. This Court held that the unitary business principle "has absolutely no relevance to the determination of whether interdependent business entities are one or more taxpayers under the act. That determination expressly has been made by the Legislature in the act." *Id.* at 703. Accordingly, this Court held that the petitioner was not allowed to "treat itself and its joint ventures as a single taxpayer either in calculating its tax base . . . or in apportioning its tax base." *Id.* Accordingly, the decision of *Wismer & Becker Contracting Engineers* was not that the unitary business principle had no application to the SBT.

The Treasury also argues that the unitary business principal is not applicable to the SBT because the SBT is a value-added tax, and no court has ever ruled that the unitary business principal is applicable to value-added taxes. We find the Treasury's argument unpersuasive. As previously discussed, the United States Supreme Court has held that due process prohibits a state from taxing activity occurring outside its borders. *Mobil Oil Corp*, 445 US at 436-437; *Allied-Signal, Inc*, 504 US at 772-773. Nevertheless, the United States Supreme Court has recognized "the impracticality of assuming that all income can be assigned to a single source." *Trinova Corp*, 498 US at 378. As explained by the United States Supreme Court in *Allied-Signal, Inc*, 504 US at 778:

> Because of the complications and uncertainties in allocating the income of multistate businesses to the several States, we permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State. That is the unitary business principle. It is not a novel construct, but one that we approved within a short time after the passage of the Fourteenth Amendment's Due Process Clause.

Accordingly, due process permits states to tax an apportioned sum of a multistate business if the business is unitary. *Id.* at 772.

While the unitary business principle is frequently applied to test the constitutionality of the apportionment of income-based taxes, no case has held that the unitary business principle is

only applicable to income-based taxes; nor would such a holding reasonably follow from the line of cases applying the unitary business principle. In *Trinova Corp*, the United States Supreme Court considered whether the SBT was constitutional. The Court explained that in the case of both value-added taxes and income-based taxes, the "discrete components" of a state tax "may appear in isolation susceptible of geographic designation." *Trinova Corp*, 498 US at 377-378. Contrary to appearance; however, the Court "recognized the impracticality of assuming that all income can be assigned to a single source." *Id.* at 378. The Court noted that like income, added value often cannot be assigned to a single source. *Id.* at 379. The Court explained that the "same factors that prevent determination of the geographic location where income is generated, factors such as functional integration, centralization of management, and economies of scale, make it impossible to determine the location of value added with exact precision." *Id.* Accordingly, apportionment is necessary in order to determine both income-based and value-added tax liability when dealing with interstate businesses. Therefore, we conclude that the unitary business principle applies to value-added taxes, such as the SBT, because the underlying realities of both income-based and value-added taxes require apportionment, and the United States Supreme Court has made it clear that the apportionment of taxes is constitutionally permitted only if the business is unitary. See, e.g., *Mobil Oil Corp*, 445 US at 439; *Allied-Signal, Inc*, 504 US at 772.[2]

III. REYNOLDS' SBT TAX BASE

The Treasury also argues that even if the unitary business principle applies, inclusion of the capital gains in Reynolds' SBT tax base is permitted because Reynolds and RAAL constitute a unitary business. The Treasury specifically argues that the Court of Claims erred by considering whether Reynolds and Worsley constituted a unitary business because Reynolds did not sell Worsley, and the capital gains were the result of Reynolds' sale of RAAL.

Questions of constitutional and statutory construction are reviewed de novo on appeal. *Fluor Enterprises, Inc*, 477 Mich at 174. We review factual findings for clear error. *Alan Custom Homes, Inc v Krol*, 256 Mich App 505, 512; 667 NW2d 379 (2003). "A finding is clearly erroneous where, after reviewing the entire record, this Court is left with a definite and firm conviction that a mistake has been made." *Id.*

[2] The conclusion that the unitary business principle is applicable to the SBT is consistent with this Court's decision in *Fluor Enterprises, Inc v Dep't of Treasury*, 265 Mich App 711, 727; 697 NW2d 539 (2005), aff'd in part rev'd in part on other grounds 477 Mich 170 (2007). In *Fluor*, this Court recognized that when the United States Supreme Court's decision in *Allied-Signal, Inc* and *Trinova Corp* are read together, they suggest that the unitary business principle applies to the SBTA. Similarly, the application of the unitary business principle to the SBT is consistent with the recent decision of this Court in *Malpass v Dep't of Treasury*, __ Mich App __; __ NW2d __ (approved for publication January 19, 2012). While the SBT was not at issue in *Malpass*, we recognized in that decision that "[i]n the absence of some underlying unitary business, multistate apportionment is precluded." *Id.*, slip op at 4.

We first address the Treasury's argument that the Court of Claims erred in considering whether Reynolds and Worsley could be considered a unitary business instead of considering whether Reynolds and RAAL were a unitary business. The Treasury accurately asserts that the sale yielding the capital gains was structured as a sale of RAAL; however, the fact that the sale was structured as a sale of RAAL does not require the conclusion that the gains may be taxed if Reynolds and RAAL constitute a unitary business. The testimony admitted during the bench trial established that RAAL was converted from a C-corporation to an LLC before its sale. The evidence indicated that when RAAL was converted to an LLC it became a disregarded entity for federal tax purposes, and RAAL was liquidated into Reynolds. Therefore, the substance of the sale was Reynolds' interest in Worsley, not RAAL. It is clear from the record that the only purpose of RAAL was to provide Reynolds with an interest in Worsley. "One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." *Mobil Oil Corp*, 445 US at 440. Therefore, while the transaction was technically structured as a sale of RAAL, the substance of the transaction was Reynolds' interest in Worsley. This conclusion is further supported by the fact that Reynolds was specifically required to dispose of its interest in Worsley pursuant to the antitrust review. Therefore, we conclude that the Court of Claims properly considered whether Reynolds and Worsley could be considered a unitary business for purposes of determining whether the capital gains could be included in Reynolds' SBT tax base. Accordingly, the issue on appeal is whether the Court of Claims erred in concluding that Reynolds and Worsley did not constitute a unitary business.

In order to determine whether separate entities form a unitary business, courts should consider three factors: "(1) functional integration; (2) centralization of management; and (3) economies of scale." *Allied-Signal, Inc*, 504 US at 781.

A review of the record reveals that Reynolds and Worsley did not form a unitary business. First, there was no evidence of functional integration. Reynolds' witnesses testified that there was no functional integration between Reynolds and Worsley. Functionally integrated enterprises tend to benefit from "common managerial or operational resources that produced economies of scale and transfers of value." *Container Corp of America v Franchise Tax Bd*, 463 US 159, 166; 103 S Ct 2933; 77 L Ed 2d 545 (1983). "[T]here [must] be some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." *Id.* In this case, the trial testimony revealed that there was no sharing of managerial or operational resources between Reynolds and Worsley. Worsley operated independently from Reynolds. Reynolds was unable to control Worsley or WAPL, and its input was limited to its three seats on the executive committee. Further, any transactions between by Reynolds and Worsley were negotiated at arms-length. Reynolds had a technology and service agreement with Worsley, but those agreements were negotiated at arms-length and Reynolds was paid the fair market value for its services. There was no sharing of research and development between Reynolds and Worsley, other than the negotiated arms-length transactions. These are not the type of intercompany transactions typical of interdependent and functionally integrated enterprises.

Second, the testimony and exhibits established that there was no centralization of management between Reynolds and Worsley. Pursuant to the joint venture agreement, the joint venturers were required to form an executive committee, which was akin to a board of directors.

Each joint venturer nominated three members to the executive committee, regardless of ownership interest. Further, the day-to-day operations were run by WAPL, an independent management company that reported to the executive committee. WAPL had its own facilities, resources, employees, and accounts, and was separate from the joint venturers. The structure of the joint venture precluded Reynolds and the other joint venturers from controlling it. Even with a fifty-six percent interest, Reynolds' input was limited to less than a majority position on the executive committee.

Finally, there were no economies of scale. Reynolds' witnesses all testified that there were no economies of scale realized between Reynolds/RAAL and Worsley. Professor Boudreaux, an expert in corporate finance and economics, stated that there was no potential for economies of scale because "in order to have economies of scale you have to have commonalities of operation" and no evidence suggested that Reynolds and Worsley had commonalties of operation that would lead to economies of scale. The Treasury presented no evidence to rebut this testimony. There was no evidence that Reynolds, RAAL, or Worsley purchased materials together or engaged in the joint production or sale of products so as to benefit from economies of scale. Rather, all of Reynolds' purchasing and production was separate from Worsley. The only connection between the two was that RAAL received a share of the alumina produced by Worsley, and Reynolds purchased the alumina from RAAL. These transactions; however, were all regulated and Reynolds paid fair-market-value for the alumina it purchased from RAAL. Therefore, no economies of scale were realized between Reynolds/RAAL and Worsley.

Relying on *Mobil Oil Corp*, the Treasury argues that Worsley was part of Reynolds' global aluminum business, and was accordingly connected to Reynolds' operations in Michigan such that it could be included in Reynolds' tax base. The Supreme Court's holding in *Mobil Oil Corp* does not support the Treasury's assertion that Reynolds' capital gains from the sale of Worsley are includable in their tax base under the unitary business principle. In *Mobil Oil Corp*, the Supreme Court Stated "[s]o long as dividends from subsidiaries and affiliates reflect profits derived from a *functionally integrated enterprise*, those dividends are income to the parent earned in a unitary business." *Mobil Oil Corp*, 445 US at 440 (emphasis added). Thus, it is not enough that Worsley contributed to Reynolds' worldwide operations. Apportionment of the capital gains is only appropriate if it reflects income derived from a functionally integrated enterprise. There was no functional integration between Reynolds and Worsley. Therefore, the capital gains could not be included in Reynolds' SBT tax base. Accordingly, we conclude that the Court of Claims did not clearly err when it found that Reynolds and Worsley were not a unitary business and that as a result, Michigan could not include the capital gains from the sale of Reynolds' interest in Worsley in Reynolds' SBT tax base.

The Treasury also argues on appeal that the Court of Claims committed error requiring reversal because it permitted expert testimony regarding the unitary business principle that included legal conclusions. On appeal, the Treasury fails to specifically identify the allegedly objectionable testimony; it also fails to cite any supporting authority for its argument. Accordingly, the Treasury has waived this argument on appeal. See *Nat'l Waterworks, Inc v Int'l Fidelity & Surety, Ltd*, 275 Mich App 256, 265; 739 NW2d 121 (2007) ("A party may not merely announce a position and leave it to this Court to discover and rationalize the basis for the claim."). Nevertheless, we note that evidentiary errors do not require reversal unless the error

affected a substantial right. See MRE 103(a); *Craig v Oakwood Hosp*, 471 Mich 67, 76; 684 NW2d 296 (2004). Even assuming the Treasury's assertion is correct and the expert gave testimony that included impermissible legal conclusions, the Court of Claims specifically stated that it would allow the expert testimony "with the caveat that the Court makes the final ruling on what the law is." See *Carson, Fischer, Potts & Hyman v Hyman*, 220 Mich App 116, 122-123; 559 NW2d 54 (1996) ("[T]he opinion of an expert may not extend to the creation of new legal definitions and standards and to legal conclusions."). Accordingly, it is clear that the Court of Claims did not base its decision on any legal conclusion made by the expert. Therefore, reversal is not warranted.

Affirmed.

/s/ Joel P. Hoekstra
/s/ Mark J. Cavanagh
/s/ Stephen L. Borrello